Revisiting Legal Realism: The Law, Economics, and Organization Perspective

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Although American Legal Realism fell on hard times, the objections of the Realists with legal formalism had substance earlier in the century and have substance today. As developed in this paper, there are many parallels between Legal Realism and older style institutional economics. Both failed for lack of operationalization.

The New Institutional Economics works out of a law, economics, and organizations perspective and takes operationalization much more seriously. This same approach could be applied to the concerns of Legal Realism, bringing added value in the process.

1. *Introduction*

The contrast between American Legal Realism, which 'ran itself into the sand' (Schlegel, 1979, p. 459), and the law and economics movement, which is 'perhaps the most important development in legal thought in the last quarter century' (Posner, 1986, p. xix), is dramatic. That one foundered while the other flourished is explained largely by the absence of an intellectual framework for Legal Realism and the use by law and economics of the powerful framework of neoclassical economics.

Although movements that lack a 'coherent intellectual force' (Schlegel, 1979, p. 459) ordinarily collapse, the concerns of Legal Realism do not go away. Some may regard that as stubborn refusal to admit defeat, but many social scientists share the conviction of the Legal Realists that 'announced legal rules may differ from what courts actually do and that embedded presuppositions regarding the law's effects and relevance to social behavior are often quite wrong, and at the very least, worthy of serious testing'

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(Johnston, 1993, p. 217). I am persuaded that the objections of the Realists with legal formalism had substance earlier in the century and have substance today (Kalman, 1986).

Given the perceived limitations of neoclassical economics (Ackerman, 1986, p. 940), Bruce Ackerman counsels that lawyer-economists should 'look to the sciences of culture ... anthropology, sociology, and sociolinguistics' (1986, p. 942) to supply the missing framework. Because, however, the 'economic approach' is very powerful and much broader than neoclassical economics, my suggestion is to combine law, economics and organization (in relation to which economics is the first among equals) in a concerted effort to study 'law as it is'. Such a program is related to, but different from, that of law and economics. Among the differences is that law and economics is more of a normative and one-way enterprise (orthodox economics is brought to bear on the law) whereas the law, economics and organization program is positive and more thoroughly interactive: economics both informs and is informed by law and organization.

Law, economics and organization can be variously implemented, depending on the perceived needs. Transaction cost economics is one such effort, the perceived need being to move beyond the proposition that institutions matter to show that institutions are also susceptible to analysis (Matthews, 1986, p. 903), which is the project associated with the New Institutional Economics. The New Institutional Economics come in two branches: the institutional environment and the institutions of governance (Davis and North, 1971). The institutions of governance are what mainly concern me in this paper. For a combined treatment, see Williamson (1993a).

There are many parallels between Legal Realism and older style institutional economics. Conceivably, efforts to deal with the needs and limitations of older style institutional economics will also have application to Legal Realism. This paper explores that possibility.[1] Comparisons of two kinds are set out in Section 2: law and economics is compared with law, economics, and organization; and older style institutional economics is compared with Legal Realism. The transaction cost economics project is then sketched in Section 3. The value added of law, economics, and organization in relation to law and economics is the subject of Section 4. Legal Realism is revisited in Section 5. Concluding remarks follow.

[1] This paper does not deal with the 'legal process' successors to Legal Realism, as represented especially by Hart and Sachs (1994). For a overview of that project, see Eskridge and Frickey (1994). The importance attached to private ordering, mechanisms and safeguards by legal process (Eskridge and Frickey, 1994, pp. xciii-xcv) are plainly ones to which transaction cost economics relates. Operationalizing these good ideas eluded the legal process approach.

2. *Some Background*

Comparing L&E with LEO

Although I mainly focus on the differences between law and economics (L&E) and law, economics and organization (LEO), there are many similarities. Both were inspired by Ronald Coase (1937, 1960, 1992); both have taken shape during the past 30 years; both hold that economics is the key discipline; both have been brought to bear on some of the same problems of public policy; and both are much closer to each other than to other interdisciplinary approaches to legal study, such as feminist jurisprudence, law and literature, and critical legal studies. Indeed, although L&E and LEO are sometimes viewed as rivals, they are often complementary.

There are, however, real differences between pronouncing (normatively) 'This is the law here' and inquiring (positively) 'What's going on here?' (D'Andrade, 1986). The first of these is closer to the L&E project. LEO is much more concerned with figuring out how feasible forms of organization work—glitches, dysfunctions, breakdowns, purported perversities and the like included. As developed later in the paper, the science of organization needs to be apprised of all regularities whatsoever, intended and unintended alike. Not only is Richard Posner, who is the leading spokesperson for L&E (Ellickson, 1989), dismissive of organization theory (Posner, 1993), but other practitioners of L&E, like orthodox economists more generally, make little or no provision for organization theory. In the degree to which organization matters, that misses some of the action, which in turn can be (and has been) the source of avoidable public policy error

Perhaps the simplest way to distinguish L&E from LEO is to observe that the three-way intersection of law, economics, and organization deals with only a subset of the problems with which law and economics is concerned (see Figure 1). Since there is general agreement that law and economics is a success story, and if law and economics has greater scope, where does the value added of LEO reside?[2]

At a general level, L&E is the application of orthodox economics (economics as presented in the microeconomics textbooks) to the law. That is an ambitious undertaking and is what the 'economic analysis of law' is all

[2] In a general sense, what LEO brings in is much more self-conscious attention to institutions. Robert Ellickson interprets Figure 1 (in his letter to me of 31 October 1995) as follows:

> As you know, much of law deals with relations among persons who are likely to be strangers. The cores of tort law and criminal law offer examples. An 'organization perspective' ... has little relevance in situations where persons are unlikely or unable to contract with one another.

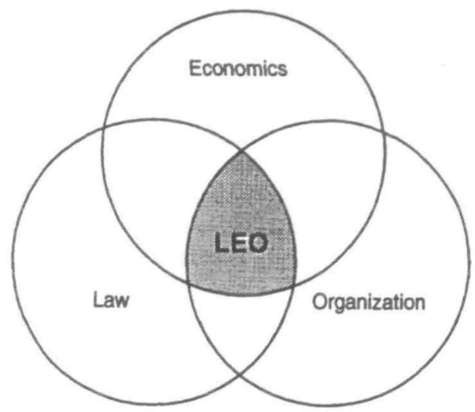


FIGURE 1. Law, economics and organization.

about.[3] In contrast, LEO works out of an 'economic approach' that is informed by both law and organization. Figure 2 displays the schematic differences.

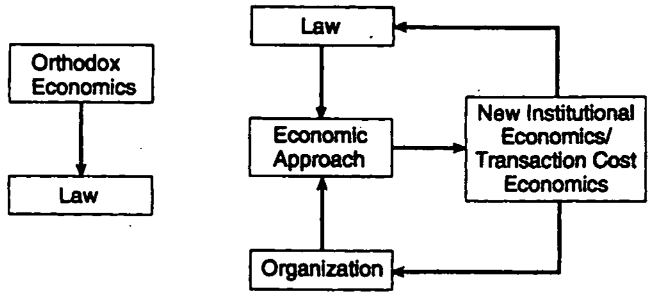
As shown in (a) in Figure 2, LEO is construed as a one-way enterprise in which orthodox economics is used to interpret and advise the law. In contrast, (b) shows economics as being informed by both law and organization, the three-way product of which is the New Institutional Economics (of which transaction cost economics is a part). The object of the latter is to reshape the way economists and other social scientists think about and investigate the purposes served by economic and political institutions.

Among the ways in which L&E and LEO differ are that the former works predominantly out of a firm-as-production function construction in which contracts are assumed to be complete (or at least comprehensive) and the action is concentrated in *ex ante* incentive alignment whereas the latter works out of a firm-as-governance structure construction in which contracts are assumed to be incomplete and the action is concentrated in the mechanisms of *ex post* governance. David Kreps contrasts the orthodox

I do not disagree, although organization can be brought to bear in the following sense: individuals who are aware of differential hazards of accidents and criminality will organize differently (as in protected communities).

In the degree to which *ex ante* incentive alignment (get the relative prices right) solves a problem of law, LEO has little to add. The value added of LEO comes in if and as *ex post* governance is also important (get the institutional supports right).

[3] Richard Posner's famous book, now in its 4th edition, is titled *Economic Analysis of Law*. See also Posner (1993, p. 83). Polinsky's book, (1983) proceeds similarly. Cooter and Ulen likewise apply orthodox economics to the law, although a reverse flow from legal formalism to economics is also contemplated (1988, p. 13).



(a) law and economics (b) law, economics and organization

FIGURE 2. Comparing law and economics with law, economics and organization.

theory of the firm with that of transaction cost economics as follows (1990, p. 96):

> The [orthodox] firm is like individual agents in textbook economics, which finds its highest expression in general equilibrium theory (see Debreu, 1959; Arrow and Hahn, 1971). The firm transacts with other firms and with individuals in the market. Agents have utility functions, firms have a profit motive; agents have consumption sets, firms have production possibility sets. But in transaction-cost economics, firms are more like markets—both are arenas within which individuals can transact.

Firms and markets are *alternative* modes for mediating transactions under the latter prescription.

Indeed, this move from a technological construction (the firm-as-production function) to an organizational construction (the firm-as-governance structure) is basic to the entire transaction cost economics enterprise. The former holds that the firm is a black box, according to which inputs are transformed into outputs according to the laws of technology; the latter is a comparative institutional construction according to which the mechanisms of governance differ among alternative modes of governance and have real consequences. Organization is ignored and is conceptually irrelevant under the former; organization matters crucially and is susceptible to analysis under the latter.

Among the questions that fall within the LEO intersection are those posed by Coase (1937): Why is there a firm at all? Why is not all production organized in one large firm? What determines the boundaries of the firm? Posing a series of fundamental and related questions for which orthodoxy had no good responses suggested the need for a new outlook. Indeed, that is the way that Coase came to view the project.

Thus, although Coase is deservedly credited with being one of the 'four founders' of the law and economics movement, Coase disclaimed an interest in the economic analysis of the law: 'I have no interest in lawyers or legal education... My interest is in economics, and I was interested in carrying forward the *Journal of Law and Economics* because I thought that it would change what economists did' (Coase, 1983, p. 192). In the degree to which legal institutions come into the analysis—'I do think some knowledge of legal institutions is essential for economists working in certain areas' (Coase, 1983, p. 193)—'it's what [institutions do] to economists that interests me, not what it does to lawyers' (Coase, 1983, p. 193).

Coase's Nobel Prize lecture reaffirms this orientation:[4]

> The time has surely gone in which economists could analyze in great detail two individuals exchanging nuts for berries on the edge of the forest and then feel that their analysis of the process of exchange was complete, illuminating though this analysis may be in certain respects. The process of contracting needs to be studied in a real-world setting. We would then learn of the problems that are encountered and of how they are overcome, and we would certainly become aware of the richness of the institutional alternatives between which we have to choose. (1992, p. 718).

Institutions are plainly where the economics research action resides and the operationalization of a New Institutional Economics is the challenge.

Transaction cost economics is an effort to implement the move from equilibrium analysis (orthodoxy) to comparative institutional analysis. In comparison with the law and economics movement (Figure 2(a)), which has 'no, or at least very few, aspirations to change economic theory' (Posner, 1993, p. 82), transaction cost economics is less deferential to orthodoxy. If institutions are important in ways that are neglected by orthodoxy, then a more thoroughly interdisciplinary treatment (possibly along the lines of Figure 2(b)) may be needed.

[4] Whereas his 1937 article on 'The Nature of the Firm,' which inspired the New Institutional Economics, and his 1960 article on 'The Problem of Social Cost,' which inspired law and economics, are given symmetrical treatment by those who prepared Coase's Nobel Prize citation, Coase gives much greater prominence to the first of these in his Nobel Prize lecture. Not only is the lecture titled 'The Institutional Structure of Production,' but it is concerned with the law only as this helps to solve puzzles of firm and market organization, which has been his abiding interest. His famous article on 'Social Cost' is thus introduced with the statement that 'I will not say much about its influence on legal scholarship, which has been immense, but will consider its influence on economics, which has not been immense, although I believe that in time it will be' (Coase, 1992, p. 717). And he indicates that the main importance of the 'Social Cost' article is not in its use of the fiction of zero transaction costs, which is what originally fascinated so many economists and legal scholars (although this is changing), but by placing positive transaction costs (specifically, differential transaction costs) at the center of the economics research agenda.

Parallels Between Legal Realism and Older Style Institutional Economics

Both Legal Realism and older style institutional economics were contemporary movements. Both took exception with formalism (in law and economics, respectively). Neither knew how (or tried hard) to operationalize its program. And both fell on hard times.

Orthodoxy. The orthodoxy that was of concern to Legal Realism was that of legal formalism, while the orthodoxy with which institutional economics took exception was that of neoclassical economics. The principal exponent of legal formalism was Christopher Columbus Langdell, who was dean of Harvard Law School from 1870 to 1895 and 'preached that all law should be reduced to a set of well-categorized rules and principles' (Kalman, 1986, p. 11). Langdell and his associates introduced the 'case method', where students learned the law by studying appellate opinions. Whereas previously lawyers were trained mainly during their apprenticeship, 'Langdell transferred the study of law from the office to the university' (Kalman, 1986, p. 11).

Reservations notwithstanding, legal formalism carried the day. Thus, although Oliver Wendell Holmes 'cursed the casebook and announced that the life of the law was not logic but experience' (Kalman, 1986, p. 13), he nevertheless conceded that the casebook was of 'unequalled value' as a pedagogical device (Kalman, 1986, p. 14). Dissent with legal formalism was nevertheless building and the American Law Institute's Restatement of Law project in 1923 has been described as 'the final effort to realize Langdell's ideal of a science of law' (Kalman, 1986, p. 14).

The economic orthodoxy with which the institutional economists took exception had much earlier origins. Adam Smith's concerns with institutions had given way to a progressively more formal program. Mainly that was the product of efforts to make economic reasoning more rigorous (Ricardo, 1817; Mill, 1848; Marshall, 1890). Efforts to mathematize economics (Cournot, 1838; Walras, 1874; Edgeworth, 1881) were especially neglectful of institutions. Ideas of utility maximization and equilibration at the margin were featured, together with a preoccupation with supply and demand and with prices and output—to the neglect of limits on cognitive competence and with scant attention to evolutionary process considerations or to the economizing purposes served by institutions.

Influential objections to orthodoxy were registered by Thorstein Veblen as early as 1898. John R. Commons's two-volume *Institutional Economics*, published in 1934, was the capstone. Veblen's much quoted description of

'The hedonistic conception of man [as] that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire and happiness under the impulse of stimuli that shift him about the arena, but leave him intact' (1898, p. 389) is repeated (with variation) by Commons (1931, p. 650). But Commons went further. He not only described an institution as 'collective action in control, liberation, and expansion of individual action' (Commons, 1931, pp. 647, 651, 654), but he joined this with the idea that the study of transactions involved simultaneous attention to conflict, mutuality, and order (Commons, 1932, p. 4). Evidently something more than equilibration at the margin was going on for which analysis was needed.

Although Commons worked off of the taxonomy of jural opposites and jural correlatives of Wesley Newcomb Hohfeld (1913), this remained a sterile taxonomy and other institutional economists relied little on the Realists. For their part, the Realists appealed to institutional economics for 'a sense of external approval' (Duxbury, 1995, p. 103) and a show of commonality (Kalman, 1986, pp. 16–19; Duxbury, 1995, pp. 97–111), but a productive joinder never materialized. Mainly, these two were separate reactions to the excesses of formalism that each ascribed to its respective form of orthodoxy.

Multidisciplinary. Legal Realism was unusually eclectic, appealing to economics, sociology, psychology, anthropology, linguistic theory and statistics (Kalman, 1986, pp. 15–20). The object in each case was to bring the law into closer contract with reality. That common purpose aside, however, an overarching unity in the project is not apparent.

Institutional economics also appealed to other disciplines, including in particular psychology and sociology, but also found inspiration in the law. Indeed, the processes of the common law were ones to which Commons expressly related in an article auspiciously titled 'Law and Economics' (1924).

Multidisciplinary, however, is different from interdisciplinary, where the latter aspires to a genuine integration of two or more disciplinary perspectives. Legal Realism never really perceived the project in this fashion, and institutional economics made only limited headway.

Leading minds. Both movements benefited from the involvement of leading minds. As Kalman observes, Legal Realism at Yale 'had a major impact upon some of the most prominent lawyers and judges of this century, including William O. Douglas, Thurman Arnold, Jerome Frank, and Abe

Fortas' (1986, p. xi). Karl Llewellyn, at Columbia, was the leading intellectual force (Duxbury, 1995, p. 68), but Robert Maynard Hutchins played an important early administrative role at Yale along with his successor as dean, Charles E. Clark (Kalman, 1986). Indeed, the list of prominent names goes on.

Whereas Veblen seems to have been self-inspired (Dorfman, 1947), Commons's interests in institutional economics were clearly stimulated by his teacher (and early luminary in the American Economic Association) Richard T. Ely. Another institutional economist who left a lasting mark on the economics profession through his leadership of the National Bureau of Economic Research was Wesley C. Mitchell, who eschewed theory in favor of meticulous empirical investigation.

Institutions matter. Moreover, both movements were persuaded that institutions mattered and had many good ideas to support that proposition. Veblen emphasized evolutionary considerations and the importance of process. Commons also related to the latter and developed an elaborate taxonomy that was intended to illuminate process but ended in obscurantism. A recurrent theme in Commons is collective action in control of individual action. He argued in this connection that orthodoxy was neglectful of the need for institutionalized rules to constrain individual action because of a presupposed harmony of interests (Rutherford, 1994 pp. 13–14).

An important, but underdeveloped idea in Legal Realism is that the concept of contract-as-legal rules was too legalistic and needed to make way for the purposive idea of contract-as-framework (Llewellyn, 1931). More generally, Legal Realism disputed that judicial opinions were rule-governed and objective but held that they were contextual and rationalized instead (Kalman, 1986):

> The realists preached that law should be studied as part of society; they concentrated their attention on facts rather than concepts; they spent their time studying law's operations and showing that judges made law rather than formulating ethical legal rules or arguing that a higher law guided judges; they believed in objectivity and sometimes in reform as well; and they sought to make the subject of their work relevant to contemporary practitioners (Kalman, 1986, pp. 37–38).

Public policy. Both Legal Realism and institutional economics were enormously influential in public policy, especially during the Great Depression when the felt-needs to reform public policy in a timely way were especially pressing. Initially, in the state of Wisconsin and later in Washington, DC, Commons and his colleagues and students played a large part in shaping

public utility and railroad regulation, in labor legislation, in social security, and, more generally, in public policy toward business.

Indeed, the Legal Realists were even more active in their service to the government during the New Deal.[5] 'Berle, Dowling, Arnold, Douglas, Frankfurter, and Frank ... [helped] to shape ... major administrative agencies [and] important systems of rules, such as the Uniform Commercial Code, were crafted by realists' (Fisher, Horwitz, and Reed, 1993, p. xiv). John Henry Schlegel lists:

> ... Douglas's work in securities law, Clark's work on procedural reform that culminated in the adoption of the Federal Rules of Civil Procedure, Llewellyn's work on reforming sales law that ultimately produced the Uniform Commercial Code, Hamilton's work on destroying economic due process, Arnold's work at reviving the antitrust laws, and Borchard's tireless activities on behalf of the Federal Tort Claims Act and the declaratory judgment. What holds these diverse activities together is that at the time they were seen as liberal, reformist projects. One of the characteristics of Realism as a movement was its slightly left of center politics (1979, p. 570, n. 589).

Impatience, non-cumulative, implosion. Perhaps partly because the policy problems were so pressing, both Legal Realism and institutional economics failed to go beyond good ideas of an informal kind into preformal and semi-formal (to say nothing of fully formal) modes of analysis. Operationalization was never seriously contemplated and a cumulative research tradition replete with refutable implications and empirical testing never developed.

As a consequence, 'As a coherent intellectual force in American legal thought American Legal Realism simply ran itself into the sand' (Schlegel, 1979, p. 459). The schism between the needs of social science research, to do 'modest, slow, molecular, definitive work', and those of progressive reformers, who perceived the need to reshape the study of the law but who put activism ahead of analysis, has been described as follows:

> ... the social scientists found unacceptable the unwillingness of the lawyers interested in empirical research to act in support of the methodological imperatives of the nascent social scientific discipline and would not provide the continuing support for that research. Similarly, the sympathetic legal community, locked in the progressive reform tradition, found empirical legal research that was unrelated to its current reform interests irrelevant and, thus, would not provide continuing support of such research (Schlegel, 1979, p. 544).

[5] Neil Duxbury concedes that many of those associated with the Realist movement went to Washington during the New Deal but argues that 'they did not necessarily take their realist ideas with them, ... [whence] realist jurisprudence made a fairly limited impact on American politics in the 1930s' (1995, p. 155).

The early commitment of Legal Realism to empirical social science thus unravelled, it being thought to be unnecessary by some (Schlegel, 1979, p. 512) and a nuisance by others: 'Fact gathering that did not advance an immediate reform objective was scholarship not worth publishing, just as fact gathering that did not fit their model of how the world was structured was an 'irrelevant jumble of figures" (Schlegel, 1979, p. 519). Driven, as some of it plainly was, by 'the right kind of politics' (Duxbury, 1995, p. 4), the quest for an 'interdisciplinary legal science proved futile' (Duxbury, 1995, p. 90).

Criticisms of the old institutional economics by economists have been scathing. Thus, Stigler remarks that 'the school failed in America for a very simple reason. It had nothing in it except a stance of hostility to the standard theoretical tradition. There was no positive agenda of research' (Stigler, 1983, p. 170). Similar views are expressed by R. C. O. Matthews (1986, p. 903) and Coase agrees: the work of American institutionalists 'led to nothing.... Without a theory, they had nothing to pass on' (Coase 1984, p. 230). Sociologists concur: older style institutional economics was largely descriptive, historically specific and non-cumulative (DiMaggio and Powell, 1991, p. 2; Granovetter, 1988, p. 8).

3. *Transaction Cost Economics: A Sketch*

Transaction cost economics is a comparative institutional approach to economic organization in which law, economics and organization are joined. The transaction is made the basic unit of analysis and the object is to align transactions with alternative modes of governance (markets, hybrids, hierarchies, bureaus) so as to effect a transaction cost economizing result. Numerous refutable implications accrue to this framework, in relation to which the data are broadly corroborative. Figure 3, which elaborates upon Figure 2(b), identifies the key features.

Law

The aspect of the law to which transaction cost economics principally appeals is that of contract law. In fact, and as discussed further in Sections 4 and 5, that has a broad reach: 'the seminal and classic subject of American legal education [is contract]' (Rubin, 1995, p. 1). Of special importance to transaction cost economics is Karl Llewellyn's concept of contract as framework (as opposed to the orthodox concept of contract as legal rules).

The Restatement of Contracts defines contract as 'a promise or set of promises for the breach of which the law gives a remedy, or the performance

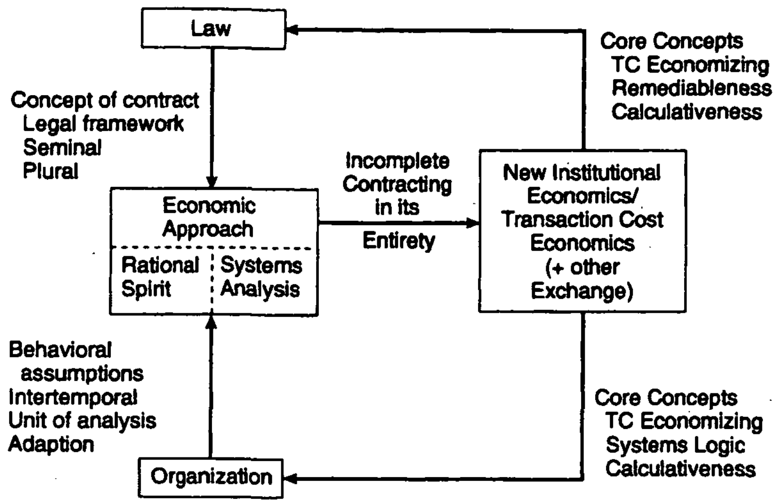


FIGURE 3. Law, economics and organization.

of which the law in some way recognizes as a duty'. Such a legalistic approach to contract has obvious appeal and 'Law and economics scholars who work in the classical tradition assume that an actor will both know and honor legal rules' (Ellickson, 1989, p. 40). That the legal rules are usually known is probably reasonable for commercial contracting, where contracts are negotiated by experienced managers with the benefit of lawyers. That the rules are efficacious is another thing (see below). That the rules will be honored is an oversimplification.

Many economists understandably concluded that what is good enough for the law is surely good enough for economics. Not only are lawyers the experts, to whom economists defer, but such a legalistic approach to contract permits economists to ignore complex problems of incomplete contract and non-market organization. Albeit a great analytical convenience to purveyors of applied price theory, that came at a high cost to an understanding of both contract and economic organization.

Indeed, there were dissenters. Llewellyn was among the leading Legal Realists who took exception with the prevailing legal rules approach to contract. Llewellyn went beyond mere criticism, moreover, and advanced the rival concept of contract as framework:

> ... the major importance of legal contract is to provide a framework for well-nigh every type of group organization and for well-nigh every type of passing or permanent relation between individuals and groups ... a framework highly adjustable, a framework which almost never accurately indi-

> cates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when the relations cease in fact to work (1931, pp. 736–737).

If, as Marc Galanter has subsequently argued, the participants to a contract can often 'devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute' (1981, p. 4), then court ordering is better regarded as a background factor rather than the central forum for dispute resolution. The costliness of courts is also pertinent to the presumed efficacy of common knowledge. If both parties could be presumed to be symmetrically informed, then inefficiency would purportedly be self-correcting because the parties would bargain to an efficient result. That, however, overlooks the possibility that one of the parties could behave strategically, represent the facts falsely, appeal to the formal contract, and ask to have the issues resolved in court. If the courts cannot be costlessly apprised of the true circumstances, then common knowledge between traders will no longer suffice. Absent the extension of common knowledge to the arbiter (which is a much more ambitious prescription), strategizing cannot be disallowed (Williamson, 1975, pp. 31–35).

Thus, although the legal technicalities of contract law remain useful for purposes of ultimate appeal, thereby to delimit threat positions, legal centralism (court ordering) gives way to private ordering as the primary arena. That is also where Hart and Sacks come out: 'private ordering is the primary process of social adjustment' (1994, pp. 161–162). Accordingly, the organization of economic activity, including the offer and acceptance of credible commitments, is where a significant part of the analytical action resides.

Not only is the orthodox preoccupation with price and output supplanted by a more microanalytic examination of transactions and of alternative forms of organization, but the idea of a single, all-purpose concept of contract is supplanted by that of contract laws (plural). Clyde Summers' distinction between black letter law on the one hand and a more circumstantial approach to contract law on the other is pertinent. 'The epitome of abstraction is the *Restatement*, which illustrates its black letter rules by transactions suspended in mid-air, creating the illusion that contract rules can be stated without reference to surrounding circumstances and are therefore generally applicable to all contractual transactions' (Summers, 1969, p. 566). Such a conception does not and cannot provide a 'framework for integrating rules and principles applicable to all contractual transactions' (Summers, 1969, p. 566). A broader conception of contract, with emphasis on the affirmative

purposes of the law and effective governance relations, is needed if that is to be realized. Summers conjectured in this connection that 'the principles common to the whole range of contractual transactions are relatively few and of such generality and competing character that they should not be stated as legal rules at all' (1969, p. 527).

Ian Macneil's distinctions between classical, neoclassical, and relational contract law (1974, 1978) are ones to which transaction cost economics easily relates. The proposition that each generic mode of organization is supported by a distinctive form of contract law is an extension of contract laws (plural) reasoning (Williamson, 1991).

Organization

The twin behavioral assumptions out of which transaction cost economics works—bounded rationality and opportunism—have organization theory origins and combine to yield the following heuristic statement of the problem of economic organization: organize so as to economize on the scarce resource of limited rationality while simultaneously safeguarding the transactions in question against the hazards of opportunism.

More important for my purposes here (since I concede that disputes over behavioral assumptions are rarely decisive) are the intertemporal process transformations to which organization theory calls attention. Very broadly, these process transformations are responsible for the proposition that organization, like the law, has a life of its own.

The study of bureaucracy and the intertemporal consequences that accrue to internal organization are important on this account (Williamson, 1990, 1993a). There are two propositions. First, the incipient science of organization needs to be apprised of all significant regularities whatsoever. Second, from an organizational design point of view, all added consequences need to be folded in, whereby unwanted costs can be mitigated and unanticipated benefits can be increased. Although sometimes the firm-as-production function construction may be altogether sufficient to ascertain the relevant consequences, organization theorists are often alert to and have helped to explicate delayed, indirect, and unintended effects.

Examples of where organization theory has deepened our understanding of complex organization are the unintended consequences that accrue to demands for control, the oligarchical propensities that accrue to leadership in organization, the ways and reasons why identity matters (including the atmospherics of organization), and the lessons for comparative economic organization that accrue to bureaucratization (Williamson, 1993a, pp. 117–119). Also, in addition to the benefits of autonomous adaptation

that Friedrich Hayek (1945) properly ascribed to markets, the benefits of cooperative adaptation that accrue to hierarchy (Barnard, 1938) also need to be recognized and taken into account.

Orthodox L&E makes little or no provision for organization. Posner, for example, advises that 'organization-theory ... [adds] nothing to economics that the literature on information costs had not added years earlier' (1993, p. 84). That literature, however, has little or nothing to say about all of the matters to which I refer above, the neglect of which is no longer acceptable.

Thus Kreps holds that 'almost any theory of organization that is addressed by game theory will do more for game theory than game theory will do for it' (1992, p. 1). Steven Postrel elaborates as follows:

> The point is that game theory does not, of itself, contain a substantive account of behavior. Game models are extremely sensitive to assumptions about information, the order of moves, constraints on action, and players' beliefs. Yet these assumptions, not game logic itself, are the real substance of a theory of business competition (1991, p. 154; emphasis omitted).

Robert Gibbons likewise advises that economists must come to terms with the internal structure and functioning of firms (1995).

Those conclusions are consonant with the transaction cost economics project. Rather than take the organization of economic activity between firms and markets as given and focus on price and output (equilibration at the margin), transaction cost economics takes the organization of economic activity as something to be derived, treats adaptation as the central problem of economic organization, and examines the differential efficacy of alternative discrete structural modes of governance in relation to the attributes of transactions. New concepts and apparatus needed to be devised in the process.

The Economic Approach

Lon Fuller's definition of 'eunomics' as 'the science, theory or study of good order and workable arrangements' (1954, p. 477) is very much in the spirit of what I refer to as governance. As Fuller subsequently remarks, 'the primary concern of eunomics is with the means aspect of the means-end relation' (1954, p. 478). Governance is also very much an exercise in assessing the efficacy of alternative modes (means) of organization. The object is to effect good order through the mechanisms of governance. A governance structure is the institutional framework within which the integrity of a transaction, or related set of transactions, is decided.

Commons also anticipated much of the conceptual argument in his

insistence that 'the ultimate unit of activity ... must contain in itself the three principles of conflict, mutuality, and order. This unit is a transaction' (1932, p. 4). Not only does transaction cost economics concur that the transaction is the basic unit of analysis, but governance is the means by which *order* is accomplished in a relation where potential *conflict* threatens to undo or upset opportunities to realize *mutual* gains.

More generally, transaction cost economics works out of the 'economic approach', of which the utility maximization that is associated with much of law and economics (Posner, 1975, 1993; Ellickson, 1989) is a special case. The economic approach combines a 'rational spirit' with a 'systems approach' to the study of economic organization.

Although all of the social sciences have a stake in rationality analysis (Homans, 1958; Simon, 1978), economists push the approach further and more persistently. As Arrow puts it: 'An economist by training thinks of himself as the guardian of rationality, the ascriber of rationality to others, and the prescriber of rationality to the social world. It is this role that I will play' (1974, p. 16). History records that that has been a productive role, for Arrow as well as more generally. Rationality is a deep and pervasive condition that manifests itself in many subtle ways.

Note in this connection that the rational spirit approach does not imply hyper-rationality. Strong form, semi-strong form, and weak form rational spirits are usefully distinguished. Whereas the strong form contemplates maximization and/or comprehensive contracting and is associated with orthodoxy, the latter two work out of bounded rationality. Semi-strong form analysis joins bounded rationality with farsighted contracting. The weak form joins bounded rationality with myopic contracting.

Transaction cost economics is a semi-strong form construction. It concedes that comprehensive contracting is not a feasible option (by reason of bounded rationality), yet maintains that many economic agents have the capacity to look ahead, perceive hazards, and draw these back into the contractual relation, thereafter to devise responsive institutions. In effect, limited but intended rationality is translated into incomplete but farsighted contracting, respectively. The concept of contract out of which transaction cost economics works is therefore that of 'incomplete contracting in its entirety', which has the appearance of a contradiction in terms. In fact, such a concept of contract presents healthy tensions to which law, economics and organization theory can productively relate. Systems considerations are posed.

Farsighted, as against myopic, contracting is *the key systems move* that distinguishes economics from the other social sciences. It is also why economics is so central to the law, economics and organization enterprise. George Schultz captures the spirit in his statement that:

> ... training in economics has had a major influence on the way I think about public policy tasks, even when they have no particular relationship to economics. Our discipline makes one think ahead, ask about indirect consequences, take note of variables that may not be directly under consideration (1995, p. 1).

Note that this is very different from the more familiar view that 'What economics has to export ... is ... a very particular and special form of [rationality]—that of the utility maximizer' (Simon, 1978, p. 2)—which is closer to the law and economics perspective. Other social scientists have been understandably wary of such trade. What was once, however, a yawning abyss between economics and the other social sciences has begun to close as non-economists, especially political scientists, have begun to recognize merit in a systems conception of farsighted (but incomplete) contracting.[6]

Ramifications for Law and Organization

Transaction cost economics subscribes to and attempts to implement the conceptual moves described above. Because the operationalization of transaction cost economics is described elsewhere (Williamson, 1985, 1989, 1991, 1996), only three key conceptual features are mentioned here: economizing, the systems logic (with emphasis on remediableness), and calculativeness.

Economizing. Transaction cost economics maintains that economizing is the main case, in relation to which other purposes (monopolizing, strategizing) require that special preconditions be satisfied (and, accordingly, are special cases). The possibility of adventitiousness/history dependence is admitted, but is examined in the context of remediableness (which restores efficiency considerations). The economizing in question is concerned principally with contract and organization (rather than technology), with special emphasis on the mitigation of contractual hazards through governance.

A recognition that hazards can take many forms has taken shape only gradually, as transaction cost economics moved beyond its initial preoccupation with vertical integration (Coase, 1937; Williamson, 1971) to consider related contractual transactions (labor, finance, vertical market restraints and other forms of non-standard contracting, regulation, trust and the like) and to push beyond governance (markets, hybrids, hierarchies, bureaus) to consider the influence of the institutional environment (the political, legal and

[6] I do not mean to suggest that L&E does not also appeal to the economic approach. It most certainly does. As described in Section 4, however, L&E emphasizes *ex ante* incentive alignment (which is in the spirit of complete contracting) whereas LEO is more concerned with *ex post* governance (incomplete contracting in its entirety). These are complementary but different exercises.

social rules of the game). Among the hazards with which transaction cost economics is concerned are (i) the aforementioned hazards of bilateral dependency, (ii) those that accrue to weak property rights,[7] (iii) measurement hazards (especially in conjunction with multiple tasks (Holmstrom and Milgrom (1991) and/or oversearching (Barzel, 1982; Kenney and Klein, 1983)), and (iv) intertemporal hazards, where these can take the form of disequilibrium contracting, real-time responsiveness, long latency and strategic abuse. Also, (v) the hazards that accrue to weaknesses in the institutional environment (North and Weingast, 1989; Levy and Spiller, 1994; Weingast, 1995) are important, need to be explicated, and are beginning to be taken into account.

Variety notwithstanding, all of these hazards entail variations on the following themes: (i) all of the hazards would vanish but for the twin conditions of bounded rationality and opportunism; (ii) the action resides in the details of transactions and the mechanisms of governance; and (iii) superior performance is realized by working out of a farsighted but incomplete contracting set-up in which the object is to use institutions as (cost effective) instruments for hazard mitigation. To repeat, the identification, explication, and mitigation of hazards through governance is what transaction cost economics is all about.

Systems Conception

Farsighted (but incomplete) contracting is to be contrasted with the myopic contracting approach that characterizes much of the organization theory literature. The contrast between the resource dependency view of specialized investments and the credible commitment treatment of those same conditions is noteworthy. Given that all complex contracts are incomplete and that promises to behave continuously in a fully cooperative way are not self-enforcing, investments in transaction specific assets pose hazards. Resource dependency theory holds that the dependent party, which varies with the circumstances, is at the mercy of the other. Working, as it does, out of a myopic perspective, the theory holds that dependency is an unwanted and unusually unanticipated condition. The recommended response to a condition of resource dependency is for unwitting victims to attempt, *ex post*, to reduce it.

Transaction cost economics regards dependency very differently because it works out of a farsighted rather than a myopic contracting perspective. Not only is dependency a foreseeable condition but, in the degree to which asset

[7] Weak property rights pose contractual hazards for which 'convoluted' forms of organization are sometimes the cost-effective response. For examples of 'inefficiency by design' see Klein and Leffler (1981), Teece (1986), Heide and John (1988) and Moe (1990a, 1990b).

specificity is cost-effective, dependency is (i) deliberately incurred and (ii) supported with safeguards. Therefore, although less dependency is always better than more, ceteris paribus, deliberate recourse to asset specificity will be undertaken in the degree to which net benefits (due allowance having been made for safeguards) can be projected.

Farsighted (but incomplete) contracting is also to be contrasted with frictionless contracting that characterizes much of the economic theory literature. The concept of remediableness arises in this connection.[8] Since all feasible forms of organization are flawed (Coase, 1964), and since choices must be made among feasible forms, a comparative institutional assessment of alternative flawed forms (of which a hypothetical ideal is not one) is needed. The concept of remediableness counsels that an outcome for which no feasible superior alternative can be described and implemented with net gains is presumed to be efficient. That collides with traditional prescriptions in applied welfare economics.

Lapses into ideal, but operationally irrelevant, reasoning will be avoided by (i) recognizing that it is impossible to do better than one's best, (ii) insisting that all of the finalists in an organization form competition meet the test of feasibility, (iii) symmetrically exposing the weaknesses as well as the strengths of all proposed feasible forms, and (iv) describing and costing out the mechanisms of any proposed reorganization. To this list, moreover, there is yet a further consideration: (v) make a place for and be respectful of politics.

This last point has been the most difficult for public policy analysts to concede, but this too is beginning to change. Avinash Dixit's recent treatment of 'transaction cost politics' is pertinent:

> The standard normative approach to policy analysis views this whole process as a social-welfare maximizing black box, exactly as the neoclassical theory of production and supply viewed the firm as a profit-maximizing black box. ... Economists studying business and industrial organization have long recognized the inadequacy of the neoclassical view of the firm, and have developed richer paradigms and models based on the concepts of various kinds of transaction costs. Policy analysis will also benefit by adopting such an approach (1996, p. 9).

Whereas normative economics holds that economics trumps politics, positive analysis places economics in the service of politics. Therefore, rather than describe political choices to which deadweight losses can be ascribed as 'failures,' positive analysis inquires into the political purposes served by indirect and even convoluted mechanisms (Moe, 1990a, 1990b). Absent a showing that these can be supplanted by feasible alternative mechanisms

[8] The earlier literature on nirvana economics (Robinson, 1934; Demsetz, 1969) is pertinent.

which will realize expected net gains, such mechanisms are presumed to be efficient (Stigler, 1992; Williamson, 1996, Ch. 8).

Calculativeness. As indicated, transaction cost economizing is held to be the main case. The concept of governance as a means by which to mitigate conflict and promote mutual gain is central to the exercise and gives the project broad scope. Not only can a wide variety of phenomena be examined in this way, but economizing is an encompassing concept. Accordingly, there is little need—indeed, often, there are real costs—in moving outside of the economizing framework to introduce user-friendly terms such as fairness, justice, trust and the like. That is because the 'missing values' that these terms are intended to convey are already operative within the far-sighted contracting/economizing set-up.

Compare, for example, Frank Michelman's treatment of takings in the context of transaction costs (which take the form of spillover costs, demoralization costs and administrative costs) with the more diffuse notion of 'justice as fairness' (Michelman, 1967; Williamson, 1970). Not only is the latter a vague (and therefore manipulable) criterion for deciding whether or not to compensate, but it is not obvious that adding fairness onto an efficiency assessment adds anything whatsoever.

Or consider the view that 'When we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him' (Gambetta, 1988, p. 217). I maintain that the condition in question should be described not as trust but as calculated risk and that to substitute the more user-friendly term (trust) for the more calculative expression (risk) invites confusion (Williamson, 1993b).

Elizabeth Hoffman *et al.* advise similarly with respect to 'reciprocal altruism.' Altruism is a user-friendly word, but it is wholly expendable in most cases where the agents are deciding whether to cooperate in terms of intertemporal reputation effects. If altruism is conditional on the expectation of reciprocation, it scarcely qualifies as altruism at all: 'I am not really being an altruist if my action is based entirely on my expectation of your reciprocation' (1995, p. 17). The exercise being wholly calculative, adding altruism to reciprocity makes a clear concept obscure.

The calculative approach of examining incomplete contracts in their entirety and folding in consequences *is an effort to mitigate hazards and avoid regret*. Thus construed, it is hard-headed but not mean-spirited. As between being calculative and uncovering the deep structure and being user-friendly but superficial, the choice is easy.

Note, moreover, that being relentlessly calculative does not imply that economics trumps either politics or organization. The object is to understand politics and organization, which places comparative institutional analysis in the analytic service of politics and organization.

4. L&E in Relation to LEO: Specific Comparisons

Does the LEO perspective have real consequences? Do the moves described in Figure 3 really matter? Opinions differ on this. Thus, Posner holds that 'When the new institutional economists study long-term contracts and corporate governance and vertical integration and property rights and the like, they are doing the *same thing* that the law and economics scholars do when they study the same subjects' (1993, p. 85; emphasis added). Those who do the same thing should come to the same result. As set out below, real differences are sometimes obtained.

Even, however, where they come out roughly the same, as they do, for the most part, on matters of vertical market restrictions and of strategic anticompetitive behavior, there are still advantages in having the microanalytics of contractual restrictions and strategic behavior worked out. Not only is this interesting in its own right, but more nuanced policy will sometimes result (Williamson, 1979, 1987c; Kenney and Klein, 1983; Masten and Snyder, 1993). Often, moreover, the public policy insights of L&E need to be delimited. The use of franchise bidding to control natural monopoly (Demsetz, 1968; Stigler, 1968; Posner, 1972) is an inspired idea, provided that the requisite preconditions are satisfied. Neglect of those preconditions, however, is fateful. Uncovering and explicating those conditions is an institutional economics exercise in which the attributes of transactions and governance structures are key (Williamson, 1976; Goldberg, 1976; Priest, 1993).

Does, however, the LEO perspective extend beyond antitrust and regulation to offer value-added more generally? I believe that it does. Applications to the study of redistribution, the efficient use of debt and equity, and the study of contract are examined here.

Redistribution

The mechanisms of redistribution out of which politics works are often convoluted and incur large deadweight losses. An oft-cited example is the US sugar program, which has been described by Stigler as follows (1992, p. 459):

> The United States wastes (in ordinary language) perhaps $3 billion per year producing sugar and sugar substitutes at a price two to three times the cost

> of importing the sugar. Yet that is the tested way in which the domestic sugar-beet, cane, and high-fructose-corn producers can increase their incomes by perhaps a quarter of the $3 billion—the other three-quarters being deadweight loss. The deadweight loss is the margin by which the domestic costs of sugar production exceed import prices.

The usual interpretation is that such deadweight losses represent inefficiency: 'The Posnerian theory would say that the sugar program is grotesquely inefficient because it fails to maximize national income' (Stigler, 1992, p. 459). A contributing factor, according to efficiency of the law scholarship, is that the sugar program is statute-based (as against common law-based) in origin.

Stigler disagrees. Observing that the sugar program has been renewed for more than 50 years, he declares that the program has 'met the test of time' and should be regarded as efficient (1992, p. 459), where efficiency is judged with reference to its political purposes rather than to an abstract economic ideal, the absence of deadweight loss:

> 'Maximum national income ... is not the only goal of our nation as judged by policies adopted by our government—and government's goals as revealed by actual practice are more authoritative than those pronounced by professors of law and economics' (Stigler, 1992, p. 459).

Transaction cost economics is much closer to Stigler's assessment. Because, however, the test of time comes perilously close to a tautology, efficiency in politics should be treated as a rebuttable presumption. Inefficiency in politics implies either that the overall political process is egregiously defective and needs to be reformed or that particular programs have unacceptable origins or have evolved in unacceptable ways. The mechanisms of politics are therefore where the action resides (Williamson, 1996, Ch. 8), which is very different from conventional deadweight loss analysis. Is the political process in question judged to be well-working (which is a general test)? Is the mechanism through which redistribution is accomplished unacceptably convoluted in a particular case (which is a local test)? Is the condition in question remediable?

This does not deny that the deadweight loss analysis to which L&E appeals is an instructive place to start, but merely to display deadweight losses in relation to a hypothetical ideal is not dispositive. It is elementary that hypothetical ideals are utopian. Since the operational choices are necessarily restricted to feasible alternatives, an extant political outcome for which no feasible superior alternative can be described and implemented with net gains is held to be efficient—unless either of the exceptions referred to above applies.

Debt and Equity

The pure finance theory of debt and equity was set out in the classic paper by Modigliani and Miller, the key result of which is that '*the average cost of capital to any firm is completely independent of its capital structure and is equal to the capitalization rate of a pure equity stream of its class*' (1958, pp. 268–269; emphasis in original). This paper has had a lasting effect on the study of corporate finance and is an elegant, early illustration of the power of farsighted contracting. Because individual investors can engage in home-made diversification of their own portfolios, the cost of capital in a firm is determined entirely by the fundamentals.

Although the strong version of the Modigliani-Miller theorem has since been qualified to make provision for taxes and bankruptcy, financial signaling, resource constraints and bonding, only the last of these introduces governance considerations. Moreover, none of these qualifications regards investment as a transaction for which the discriminating alignment of governance features with the attributes of the transaction would serve to economize on transaction costs. That is because debt and equity are merely financial instruments (rather than governance instruments) under the orthodox set-up.

Frank Easterbrook and Daniel Fischel appeal to Modigliani-Miller (the financial instrument view) for the proposition that 'There is no fundamental difference between debt and equity from an economic perspective' (1986, p. 274, n. 8). Posner likewise invokes the Modigliani-Miller theorem to support the proposition that 'it is unlikely that the value of shareholders' equity can be increased by altering the debt-equity ratio' (1986, p. 411) and elsewhere appeals to differential risk aversion to explain lending by banks (1986, p. 370):

> ... the shareholder is likely to be more risk averse than the bank. Remember that we are talking about how to get individuals to invest money in enterprises. Of course corporations can be shareholders too, but the ultimate investors are individuals, and most individuals, as has been noted many times in this book, are risk averse.

Transaction cost economics holds that organization matters and asks whether debt and equity differ in governance structure respects.[9] In the event that they do, then the possibility that debt and equity align to the

[9] See Geoffrey Miller (1995) for a different but complementary treatment of debt and equity in which governance is featured. Also note that Easterbrook and Fischel appear to have moved away from a strict Modigliani-Miller position. Without subscribing to a transaction cost view, they do recognize signaling, monitoring, and managerial incentive aspects of debt (1991, pp. 114, 176, 282). These stop short, however, of treating debt as a governance structure.

attributes of transactions is entertained. Supplanting comprehensive (Modigliani-Miller) contracting by incomplete contracting in its entirety is the key systems move.

Viewing debt and equity as governance structures reveals that debt is the more market-like instrument to which 'rules governance' applies. Equity, by comparison, is a more discretionary instrument and has attributes more akin to hierarchical governance. The predicted alignment is that the market-like instrument (debt) will be used to finance generic projects, whereas equity will be used to finance projects where the assets are more specific and discretionary governance is the source of added value (Williamson, 1988). The argument is a variation on the paradigm problem (vertical integration) out of which transaction cost economics works, according to which generic and specific assets align to markets and hierarchies, respectively. The financial data, moreover, are broadly corroborative and the argument generalizes to asset sales and reorganization (Shleifer and Vishny, 1991).

Contract

As shown in Figure 3, the box within which the New Institutional Economics/Transaction Cost Economics is located includes 'other exchange'. That is intended to signal that transaction cost economics is part of a larger project. As Kohn (1995) interprets recent developments, the basic divide is between the 'theory of value' and the 'theory of exchange', where the former refers to neoclassical economics, especially Walras (with emphasis on costless exchange, technology, equilibrium, relative prices, and Pareto Optimality), and the latter introduces costly exchange (with problems of organization, contract and remediableness).

James Buchanan's distinction between the 'science of choice' and the 'science of contract' (1975, p. 229) is broadly in this spirit. Work of the latter kind divides into that which employs a comprehensive contracting set-up and is very formal, and that in which incomplete contracting is featured. Albeit sometimes in tension,[10] these two are also often very complementary (Edlin and Reichelstein, 1995). Here as elsewhere, my emphasis is on incomplete contracting in its entirety, which is the transaction cost economics project. It bears repeating, however, that the contractual approach to economic organization is much broader than described here and has turned out to be an extraordinarily productive perspective (Werin and Wijkander, 1992).

[10] There are fundamental problems with a comprehensive contracting set-up, in that any form of organization ought to be able to replicate any other (Williamson, 1987; Hart, 1990). Some of the tensions are evident in my examination of Fudenberg *et al.* (1990) in Williamson (1991).

Albeit an oversimplification, the L&E and LEO approaches to contract correspond approximately to Llewellyn's distinction between the contract-as-legal rules and contract-as-framework. The first of these is principally an exercise in court ordering in which the competency of the courts is presumed to be great (Tullock, 1996, p. 5). The second works out of private ordering and, the competency of the courts being limited, the courts are reserved for ultimate appeal.

Thus although issues of efficient breach are treated by both L&E and LEO, the legal rules (Barton, 1972; Shavell, 1980) and private ordering (Telser, 1981; Klein and Leffler, 1981; Williamson, 1983) approaches to contract are really very different. Not only is the offer and acceptance of credible commitments—the use of hostages (in various forms) to support exchange; the design of mechanisms to display information, settle disputes, and promote continuity—more in the spirit of the purposive approach to contract (in which legal rules operate in the background), but the legal rules approach is directed principally to the needs of lawyer-economists, whereas private ordering is predominantly concerned with the economics of organization.

Might, however, the purposive approach to contract in which transaction costs are featured be employed more widely by legal scholars? Anthony Kronman's treatment of 'Specific Performance' (1978), which works off of the distinction between property rules and liability rules and the transaction cost differences that accrue thereto (as originally developed by Guido Calabresi and Douglas Melamed,1972), is plainly in this spirit. If, indeed, details which matter to the economics of organization also have ramifications for the law, then more analysis of a Kronman type could be done by working with the microanalytic attributes of transactions and the mechanisms of governance. Asset specificity, in its various forms, is an obvious candidate.

Furthermore, it would be instructive to develop the legal ramifications of differential cognitive competence (bounded rationality) as it relates to the hazards (especially intertemporal hazards) of opportunism. Holding adults to their contracts serves to concentrate the mind, yet adults are merely wiser and more experienced than minors—which is to say that they differ in degree rather than in kind. If, therefore, the attributes of deeply problematic transactions (often due to information impactedness) could be clearly identified, might it be possible to recognize exceptions to literal enforcement for a delimited set of cases to which net benefits can be ascribed? Employment relations involving hazards with long-latency effects (as with asbestos) are an example.

Ian Ayres and Robert Gertner's analysis of 'Filling Gaps in Incomplete Contracts,' which focuses on default rules, is relevant. They not only take exception with majoritarian thinking—'the 'would have wanted' approach

to gap filling' (Ayres and Gertner, 1989, p. 98)—because this is needlessly aggregative and fails to make allowance for differences to which some of the contractual parties will be mindful, but they also introduce strategic considerations. Information asymmetries are responsible for the latter and Ayres and Gertner advise that 'The strategic behavior of the parties informing the contract can justify strategic interpretations by the courts' (1989, p. 99). This last needs to be delimited, lest imaginative judges carry the argument to fanciful extremes. Can the circumstances where strategic concerns cross the threshold be described? What are the defining attributes?

Another area to which contractual analysis of a transaction cost economics kind could be applied is to the idea of contract laws (plural). Specifically, if each generic mode of governance is supported by a distinctive form of contract law (Williamson, 1991), then a broad effort (one that goes beyond markets, hybrids, and hierarchies) to investigate this is warranted. What is the (implicit) contract law of bureaus? What about non-profits (Hansmann, 1988)? Where does fiduciary law figure in? The application of transaction cost reasoning to all of these would be instructive.

Plainly, the LEO approach of these and related issues differs from what traditional L&E has been up to. As Richard Craswell and Alan Schwartz put it, 'Most articles in the law-and-economics tradition address the desirability of particular rules of contract law without addressing the more basic question of whether or why promises ought to be binding' (1994, p. 15).

5. *Revisiting Legal Realism*

'Why excavate the writings of the Realists?' William Fisher, Morton Horwitz and Thomas Reed respond to that query by observing that not only was Legal Realism an 'extraordinarily influential movement in American legal history', but the writings of the Realists 'contain many enduring insights' (Fisher *et al.*, 1993, p. xiv). Indeed 'Legal Realism continues to exert an important influence on modern American legal scholarship through its capacity . . . to define the questions that need answering' (Fisher, *et al.*, 1993, p. xiv). Thus, although Fisher, Horwitz and Reed do not dispute that American Legal Realism ran itself into the sand, their position is that American Legal Realism was onto some very important issues for which responsive scholarship is still needed.

Contemporary Legal Scholarship

Transaction cost economics maintains that any issue that arises as or can be posed as a contracting problem can be examined to advantage in transaction

cost economizing terms. Many issues, of which the make-or-buy decision (vertical integration) is one, arise directly as contracting problems. Many other issues that originally appear to lack contracting aspects turn out, upon examination, to possess them. (Thus whereas the oligopoly problem is commonly posed in market structure terms, reformulating it as a cartel problem quickly reveals its contracting structure.) The result is that the comparative contractual approach has wide reach and application to economic organization. If contract is really 'the seminal and classic subject of American legal education' (Rubin, 1995, p. 1), possibly it has wide application to the law as well.

Yet Llewellyn's concept of contract-as-framework (supported by private ordering with courts reserved for ultimate appeal) has made only limited headway. American legal scholarship still relates mainly to the legal rules tradition: 'When American legal scholars speak of 'contracts' they typically do not mean contracts at all, but rather judicial decisions ... involving disputes about contracts. Contracts themselves, the transactions that create them, and the business decision to comply with them, renegotiate them, or breach them have rarely surfaced in the academic study of [contract]' (Rubin, 1995, p. 1).

Given the disparity between contract law on the books and contract law in action, it might have been anticipated that 'Law and economics, drawn from a discipline that had no intrinsic affection for judicial decision, should have rapidly redirected the attention of legal scholars to the study of contracts and contractual relations' (Rubin, 1995, p. 3), but that did not materialize. As with tort law, where the law on the books orientation prevailed (Landes and Posner, 1987, p. 312), so too with contract.

Rubin thereupon raises the possibility that transaction cost economics will 'provide a pathway through the thickets where the legal realists and the legal economists got lost' (1995, p. 4). Clearly, transaction cost economics and Legal Realism have overlapping interests in understanding legal purpose and practice. Conceivably the economizing logic and mechanisms out of which transaction cost economics works could be put to the service of Legal Realism.

Such an undertaking is especially important if, as Rubin elsewhere observes, American legal scholarship is:

> ... in a state of disarray. It seems to lack a unified purpose, a coherent methodology, a sense of forward motion, and a secure link to its past traditions. It is bedeviled by a gnawing sense that it should adopt the methods of other disciplines but it is uncertain how the process is to be accomplished (1988, p. 1835).

Might the application of the schema in Figure 2(b), according to which economics both informs and is informed by law and organization, might Figure 2(b) help to relieve this status and recover forward motion?

Recent arguments of a related kind have been advanced by Jason Johnston, George Priest and George Stigler. Thus, Johnston observes that 'close comparative analysis of institutions is home turf for law professors' (1993, p. 216), which is very much in the spirit of law, economics, and organization. Getting beyond the Legal Realists' conviction that announced legal rules may differ from what courts actually do requires linkages with a progressive research program (Johnston, 1993, p. 218).

Related to this, George Priest observes that 'one must abandon the notion that law is a subject that can be usefully studied by persons trained only in the law' (1983, p. 437) and avers that 'the best writing about the legal system *is* interdisciplinary' (1983, p. 440), whereupon he concludes that 'the structure of the law school and its current curriculum must change' (1983, p. 440). If, moreover, 'efficiency of the law' scholarship is too narrow and must make a place for politics and organization (Priest, 1984), then something more akin to Figure 2(b) seems warranted.

George Stigler, if I interpret him correctly, also viewed the economic analysis of law as a worthy but needlessly narrow construction. His provocative essay on 'Law or Economics?' concludes by distinguishing (Stigler, 1992, p. 467):

> ... two fundamentally different roles that [economists] might play in law. The first role is simply to provide expertise on points requested by the lawyers....
>
> A second, more controversial role for economics is in the study of legal institutions and doctrines . . . [Such matters] are not exclusively legal and economic—indeed, they obviously involve the workings of the political system. Understanding the source, structure, and evolution of a legal system is the kind of project that requires skills that are possessed but not monopolized by economists.

Of these two, the second is a more ambitious and more interdisciplinary exercise. It is also more controversial: the law schools may decide that 'Such studies are not necessary and are possibly even disruptive in a discipline whose fundamental task is to train practitioners' (Stigler, 1992, p. 467).

The possible unsuitability of the program described by Stigler (and/or the project that I describe as law, economics and organization) is for others to decide. If, however, the importance of dealing with the law in action (as against the law on the books) persists, then disciplined ways by which to address the concerns of the Legal Realists will be needed. Operationalization is what permitted the New Institutional Economics to succeed where the older style institutional economics had failed. Operationalization is likewise the prescription for a New Legal Realism.

That a New Legal Realism might succeed, where the earlier Legal Real-

ism ran itself into the sand, is favored due to several considerations. First, as Rubin suggests, Legal Realism would find considerable support from the renewal of interest in institutional economics and the evolving programs of research (including transaction cost economics) that are associated therewith. Second, the law schools in the 1990s differ greatly from the 1930s. Not only do many more law school professors have social science training and social science interests today, but the law schools are much more connected (often through joint appointments) with the larger intellectual community in the university. Third, the needs for real-time reform are less pressing than in the 1930s. Finally, the opportunities for lawyers to participate in the 'special multidisciplinary conversation about law, economics, and organization' are numerous and growing:[11]

> The emerging law, economics, and organization literature has already made at least three general contributions: first, it has expanded economic analysis of law to take account of the institutional forms within which legal rules and transactions take place. In so doing it has, in the best tradition of interdisciplinary research, both increased our understanding of law and improved economic theory. Second, this literature has reached out to include the insights of other disciplines (particularly political science, sociology, and psychology) that are concerned with organizational forms and their influence on legal decision-making. Third, this broadened perspective has begun to make interdisciplinary research about law relevant to a broader group of lawyers and legal academics who do not view themselves as being associated directly with law and economics (Mashaw, 1985, p. 4).

The advantages of lawyers (or lawyer-economists), as against economists, for orchestrating a renewal of Legal Realism is that they have deep knowledge about legal phenomena—many of which remain puzzles. What is needed is to join deep knowledge about this subject matter with a productive framework. Employing the economic approach, which includes but goes beyond orthodoxy, and appealing to the New Institutional Economics/transaction cost economics, if and as institutions figure prominently in the problem, is the strategy proposed here.

Since the comparative analysis of institutions, as Johnston put it, is 'home turf' to law professors, that proposal is congruent with the natural inclinations of many lawyer-economists. A concerted move in this direction nevertheless faces obstacles. For one thing, there is always the lurking hazard that transaction cost reasoning will lapse into *ex post* rationalization. Lawyer-economists need to use and refine these concepts in a disciplined way. For another, it is much easier to see merit in a new framework than it is to work productively out of that framework. History records that legal formalism has

[11] The ideas written by Mashaw are ones with which I concurred then and to which I subscribe now.

lasting attractions—not least of all because it is familiar turf over which lawyers have undisputed control.

Be that as it may, the foregoing establishes that (i) American Legal Realism and older style institutional economics in the USA had many similarities, (ii) the transaction cost economics branch of LEO is responsive to some of the key insights of older style institutional economics, and (iii) that the concerns of Legal Realism are enduring. Also, (iv) LEO (I think) relates more closely to the needs of Legal Realism than does L&E. Might some of the lawyer-economists to whom Ackerman (1986) refers—namely, those who are disaffected with L&E yet are not fully persuaded to work through the sciences of culture—find that LEO can breathe operational life into Legal Realism as well? That is my suggestion.

Implementation

Conceptually. Although both Fuller's interests in the study of 'good order and workable arrangements' and Llewellyn's emphasis on 'contract as framework' have attracted favorable commentary from lawyers (Summers, 1984; Macneil, 1974), neither of these projects have been developed in a sustained way. Especially in combination, these two are potentially very fruitful. The former is an instructive way to think about the purposes of both law and organization. The latter supplants a legalistic view of contract with a purposive one. Taken together, and with the support of apparatus that serves to operationalize these concepts, a positive and predictive theory of contract (more generally, of the law) might be within reach.

If contract is really the unifying subject in the law, it ought to have broad application. It does. Thus, one way to interpret Coase's influential article on 'Social Cost' is that tort law is really a special case of contract law. Because parties will always costlessly contract to an efficient result in a zero transaction cost regime, externalities arise always and only because positive transaction costs make it costly to contract. The upshot is that such comparative contractual reasoning applies quite generally.

Going native. Transaction cost economics is an effort to apply comparative contractual reasoning to any problem that arises as or can be reformulated as a contracting problem. As Arrow observed, externalities are subsumed by market failures which in turn are subsumed by transaction cost (1969, p. 48). For example, the differential costs of organizing are what prevents consumers from bargaining to an efficient result with a producer cartel (Arrow, 1969, p. 51). Upon observing an 'inefficiency' of any kind, it is useful to pose three questions: What is the contract that would remove the

inefficiency? What impediments preclude this contract from being implemented? What are the best feasible contractual alternatives for dealing with this condition?

Transaction cost economics avers that the way to think about issues contractually is in an incomplete but farsighted contracting fashion. That conception of contract is saturated with tension. As between incompleteness and farsightedness, the lawyer-economist is advised to push farsightedness (more generally, the rational spirit/systems approach) to the limit—but not beyond. The object is to discover delayed or indirect consequences, to which organization theory is often attentive, thereafter to work out the ramifications for dealing more knowledgeably and effectively with the phenomena in question by folding these delayed or indirect effects back in. To be sure, looking ahead is what law and economics has been urging right along. What LEO adds, if one buys into transaction cost economics, are: (i) a view of the firm as governance structure (rather than production function); (ii) greater respect for organization and for politics more generally; (ii) greater emphasis on the purposes served by *ex post* governance (as against *ex ante* incentive alignment), (iv) a more microanalytic perspective in which the action resides in the details of transactions and governance; and (v) the remediableness criterion (whereupon failure is not established by a demonstrated deviation from a hypothetical ideal). Transaction cost economics also works out of a generalized 'economic approach' (rather than economic orthodoxy) and appeals to economizing (rather than utility maximization). Furthermore, the new institutional economics/transaction cost economics has been described as 'Politically ... neutral: it has been invoked in support of both market pessimism and market optimism' (Matthews, 1986, p. 907).

The resulting approach nevertheless remains highly calculative, and an obsession with calculativeness is widely thought to be an occupational burden—a trained incapacity—for economists. Indeed, there is a growing chorus of critics—of which Alan Fox (1974) is one of the more thoughtful and Francis Fukuyama (1995) is one of the more recent—who advise that calculativeness is the problem to which fellow-feeling and 'trust' is the solution. Surely lawyers are too wise to fall into the economists' trap.

These issues are outlined earlier in the paper and developed more extensively elsewhere (Williamson, 1993b). It is sufficient to observe here that although calculativeness can be used in a myopic and grasping way, that is not what incomplete contracting in its entirety contemplates. The object of farsighted contracting is to look ahead, recognize potential hazards, and use *ex post* governance (as well as *ex ante* incentive alignment) to reduce hazards and avoid regrets. Those who interpret that as mean-spirited contracting need to explain how they reach that result.

My proposal for implementing the study of good order and workable arrangements is therefore as follows: examine each legal issue through the lens of comparative, farsighted contracting in which transaction cost economizing is featured; be relentlessly calculative; and, because all feasible forms of law and organization are flawed, work through the remediableness criterion.

That is a stringent prescription and some lawyer-economists may prefer greater latitude. Although that is understandable (and perhaps advisable), my recommendation would be to 'go native', which is easier said than done. Thomas Kuhn speaks of the issues:

> To translate a theory or world view into one's own language is not to make it one's own. For that one must go native, discover that one is thinking and working in, not simply translating out of, a language that was previously foreign, [which can be difficult]. . . . Many who first encountered, say, relativity or quantum mechanics in their middle years . . . [found themselves] fully persuaded of the new view but nevertheless unable to internalize it (1970, p. 204).

The agenda. An ambitious way to pose the challenge is to take the table of contents in Posner's treatise *Economic Analysis of Law* as the chapter headings for a parallel book on *The Analysis of Law, Economics and Organization.* Does LEO add much or little and, where the differences are substantial, why and what do the data support?

6. *Conclusions*

Legal Realism was examining good issues, had revolutionary pretensions, and faltered for lack of a conceptual framework and scientific commitment. Successors such as 'Bickel, Hart, and Sacks ... co-opted realism and attempted to make it more rational' but lacked revolutionary zeal (Kalman, 1986, p. 231). Even more, they lacked a systematic mode of analysis from which refutable implications could be derived and to which an empirical program of research could be applied.

The program described here as law, economics, and organization also lacks revolutionary purpose but does have a scientific ambition. Conceivably, although this awaits trial, the concerns with which the Realists were grappling can be studied in a 'modest, slow, molecular, definitive' way by adopting (and, as necessary, reshaping) the framework out of which transaction cost economics operates. (See, for example, Roberta Romano, 1993 and the collection of reprinted articles in Williamson and Masten, 1995).

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